DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Date:

AUG 19 2002

Contact Person:

Identification Number:

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Employer Identification Number:

LEGEND:

X =

UIL Nos.
4942.03-02

Dear Sir or Madam:

We have considered X's ruling request dated October 19, 2001 concerning the application of section 4942 of the Internal Revenue Code.

FACTS:

X is a testamentary charitable trust created in 1962 and recognized as a private (non-operating) foundation described in sections 501(c)(3) and 509(a) of the Code. The will requires the trustee to distribute 25% of the annual net income to charitable beneficiaries and to accumulate the remainder. The will also treats dividends payable in stock or other property, and liquidating dividends, as principal rather than income. The will provides that X must terminate by no later than 20 years after the death of the last grandchild of the donor living at the time of the donor's death (in 1962) and distribute all of its assets to one or more charitable beneficiaries.

In 1971, the trustee petitioned the State court to reform the trust in light of the distribution requirements of section 4942, enacted in 1969. The court rejected the petition as contrary to the testatrix's intention.

In the late 1970s, the IRS audited X. The IRS agent concluded that section 4942 required X to distribute annually its minimum investment return less the required 75% accumulation under the will. Since the audit, X has complied with this formula, which has not been questioned on subsequent IRS audits of X.

All of X's current assets represent the initial bequest to X and income earned thereon. In 1999, X received a large cash contribution and promptly redistributed that contribution out of corpus to section 501(c)(3) organizations that are not private foundations. X will similarly promptly redistribute any future contributions it may receive.

X proposes to invest all or substantially all of its assets in one or more limited liability companies in which its assets will be pooled for investment purposes with the assets of several other foundations (all related in that they share common trustees and were all created by members of the donor's family). The pooling of investments will allow X to have greater access to expert money managers, to be subject to more favorable fee schedules, and to participate in investments that X alone would not be able to participate in because of minimum investment requirements. All of the investors will be 501(c)(3) organizations. Each foundation will have an equity interest based on the proportional value of its investment in the LLC, and each will be able to withdraw its investment at any time, subject to limitations imposed by outside money managers handling the LLC's investments. Each foundation will appoint one of their foundation managers as managers of the LLC, and they will receive no additional compensation for such service (each currently receives compensation as a foundation manager). One of the foundations will be responsible for accounting for the LLC and will charge a fair market value for this service. The LLCs will invest with various outside money managers (not disqualified persons) who will be paid no more than fair market value.

Currently, X realizes net income, as defined by X's governing instrument and applicable State law, of approximately 1%-2% of its assets annually. Applicable State law provides that any nonliquidating cash distributions from the proposed LLCs to X are income as opposed to principal. X anticipates that it will annually receive distributions from the LLCs equal to approximately 5% of X's assets invested in the LLCs, which will be treated under State law as income.

RULINGS REQUESTED:

X requests the following rulings:

1. The transition rule embodied in Section 101(l)(3) of the Tax Reform Act of 1969 and section 53.4942(a)-2(e) of the regulations (the "transition rule") will apply to X's income from its proposed investments in the LLCs.

2. If X invests all of its assets in the LLCs and receives all of its income from the LLCs, the transition rule will require X to distribute the greater of (a) the excess of the distributable amount, as defined in section 4942(d) of the Code and authorities thereunder for taxable years beginning after December 31, 1981, over 75% of X's net income from the LLCs as determined under the terms of the Will and the applicable State law, or (b) 25% of its net income from the LLCs as determined under the terms of the Will and the applicable State law.

LAW:

Section 4942 of the Code generally imposes a tax on private foundations for failure to distribute annually through "qualifying distributions" the foundation's distributable amount.

Section 101(l)(3)(B) of the Tax Reform Act of 1969 (P.L. 91-172) and section 53.4942(a)-2(e)(1)(i) of the Foundation and Similar Excise Taxes Regulations provides that in the case of organizations organized before May 27, 1969, section 4942 shall not apply to an organization to the extent its income is required to be accumulated pursuant to the mandatory terms (as in effect on May 26, 1969, and at all times thereafter) of an instrument executed

before May 26, 1969, with respect to the transfer of income producing property to such organization, except that section 4942 shall apply to such organization if the organization would have been denied exemption if section 504(a) had not been repealed by this Act, or would have had its deductions under section 642(c) limited if section 681(c) had not been repealed by this Act.

Section 101(l)(3) of the Act and section 53.4942(a)-2(e)(3) of the regulations further provide that with respect to taxable years beginning after December 31, 1971, subparagraph (B) of the Act and (1)(i) of the regulations shall apply only during the pendency of any judicial proceeding by the private foundation which is necessary to reform, or to excuse such foundation from compliance with, its governing instrument or any other instrument (as in effect on May 26, 1969) in order to comply with the provisions of section 4942, and in the case of subparagraph (B) for all periods after the termination of such judicial proceeding during which the governing instrument or any other instrument does not permit compliance with such provisions.

Sections 504(a)(1) and 681(c)(1) of the Code, as repealed by the Tax Reform Act of 1969 (P.L. 91-172), denied exemption, and limited the 642(c) deduction for amounts set aside for charitable purposes in a taxable year, for unreasonable accumulations of income. The sections provided that in the case of a trust created by the will of a decedent dying on or after January 1, 1951, if income is required to be accumulated pursuant to the mandatory terms of the will creating the trust, sections 504(a)(1) and 681(c)(1) shall apply only to income accumulated during a taxable year of the trust beginning more than 21 years after the date of death of the last life in being designated in the trust instrument. Sections 504(a)(2) and (3) and 681(c)(2) and (3) deny exemption if accumulations of income are used to a substantial degree for non-charitable purposes or for jeopardizing investments.

Section 53.4942(a)-2(e)(3) of the regulations further provides that in any case where a foundation's governing instrument or any other instrument requires accumulation of income as described in subparagraph (1)(i) beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, the distributable amount (as defined in section 53.4942(a)-2(b)) for such foundation shall be reduced by the amount of the income required to be accumulated. In any case where a foundation's governing instrument or any other instrument requires accumulation of income as described in subparagraph (1)(i) beginning with the first taxable year following the taxable year in which such judicial proceeding is terminated, the distributable amount (as defined in section 53.4942(a)-2(b)) for such foundation shall be reduced by the amount of the income required to be accumulated. Therefore, if the foundation's adjusted net income for any taxable year equals or exceeds its minimum investment return for such year, the accumulation provisions will be given full effect. However, if the minimum investment return exceeds the adjusted net income for any taxable year, the foundation will be required to distribute such excess for such year.

In Example (2) of section 53.4942(a)-2(e)(4) of the regulations, private foundation Y was created by the will of A who died in 1940. Y's governing instrument requires that 40 percent of Y's adjusted net income be added to corpus each year. In an action commenced prior to December 31, 1971, a court of competent jurisdiction rules that this accumulation provision must be complied with. In Y's succeeding taxable year its adjusted net income is $120,000, and its minimum

investment return is $140,000. Thus, Y is required to accumulate $48,000 (40 percent of $120,000) and shall be allowed to do so. Therefore, Y's distributable amount for such taxable year shall be the greater of its adjusted net income ($120,000) or its minimum investment return ($140,000), reduced by the amount of the income required to be accumulated ($48,000) and the taxes imposed by Subtitle A of the Code and section 4940 and increased by any trust distributions described in paragraph (b)(2) of this section. Accordingly, Y's distributable amount for such taxable year is $92,000 ($140,000 reduced by $48,000), before other adjustments. If Y's minimum investment return had been $120,000 instead of $140,000, its distributable amount for such taxable year would have been $72,000 ($120,000 reduced by $48,000), before other adjustments. Similarly, if Y's minimum investment return had been $100,000 instead of $140,000, its distributable amount for such taxable year would also have been $72,000, before other adjustments.

Section 53.4942(a)-2(b)(1) of the regulations provides generally that the term "distributable amount" means--

(i) For taxable years beginning before January 1, 1982, an amount equal to the greater of the minimum investment return (as defined in paragraph (c) of this section) or the adjusted net income (as defined in paragraph (d) of this section); and

(ii) For taxable years beginning after December 31, 1981, an amount equal to the minimum investment return (as defined in paragraph (c) of this section), reduced by the sum of the taxes imposed on such private foundation for such taxable year under subtitle A of the Code and section 4940, and increased by the amounts received from trusts described in subparagraph (2) of this paragraph.

RATIONALE:

Each of the requested rulings is discussed in turn below.

1. X is entitled to the benefit of the transition rule with respect to the transfer of income producing property to it, to the extent that its income is required to be accumulated under the terms of the trust instrument, because it was organized before May 27, 1969, the accumulation terms are mandatory and have been in effect on May 26, 1969 and at all times thereafter, and it timely and unsuccessfully took judicial action to comply with section 4942 of the Code. The provisions of former sections 504(a) and 681(c) prohibiting unreasonable accumulations of income do not apply to X, because it will terminate and distribute all of its assets within the applicable time period. X represents that it has complied and will continue to comply with the other provisions of former sections 504(a) and 681(c).

Moreover, we find nothing in the transitional rule to prevent its application to X's income producing property if X changes the form of its investment by transferring such property to the proposed LLCs.

2. When Treasury issued section 53.4942(a)-2(e)(3) of the regulations, section 4942(d) of the Code and 53.4942(a)-2(b) of the regulations defined the "distributable amount" generally as the greater of the mimimum investment return or adjusted net income, less section 4940

taxes. In 1981, Congress redefined the "distributable amount" generally as the minimum investment return less section 4940 taxes. Treasury subsequently amended section 53.4942(a)-2(b) of the regulations to reflect this change, but did not amend section 53.4942(a)-2(e)(3). We find that the intent of section 53.4942(a)-2(e)(3) is that the distributable amount, as defined in section 53.4942(a)-3(b) for the taxable year in question, be reduced by the amount of income required to be accumulated. Thus, for taxable years beginning after 1981, the distributable amount is calculated without regard to adjusted net income, and the last two sentences of section 53.4942(a)-2(e)(3) have no relevance.

The transitional rule allows for a lower distributable amount to the extent that X's income is required to be accumulated. X is required to accumulate 75% of its net income (as determined under State law). Thus, X's distributable amount is the distributable amount (as currently defined in the Code and regulations), less 75% of X's net income (as determined under State law). X's governing instrument requires it to annually distribute 25% of its net income as determined under applicable State law, so X's annual distribution will be at least this amount.

RULINGS:

These rulings are based on X's representation that it will promptly redistribute any future contributions. We rule as follows:

1. The transition rule will apply to X's income from its proposed investments in the LLCs.

2. If X invests all of its assets in the LLCs and receives all of its income from the LLCs, the transition rule will require X to distribute the greater of (a) the excess of the distributable amount, as defined in section 4942(d) of the Code and authorities thereunder for taxable years beginning after December 31, 1981, over 75% of X's net income from the LLCs as determined under the terms of the Will and the applicable State law, or (b) 25% of its net income from the LLCs as determined under the terms of the Will and the applicable State law.

Except as we have ruled above, we express no opinion as to the tax consequences of the transaction under the cited provisions of the Code or under any other provisions of the Code.

This ruling is directed only to X. Section 6110(k)(3) of the Code provides that it may not be used or cited as precedent.

Because this letter could help resolve future tax questions, you should keep a copy of this ruling in your permanent records.

If you have any questions about this ruling, please contact the person whose name and telephone number are shown in the heading of this letter.

Sincerely yours,

/S/

Joseph Chasin
Acting Manager
Exempt Organizations
Technical Group 2